CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
REAL ESTATE DEVELOPMENT

August 12, 1998

This Policy is effective immediately upon adoption and supersedes all previous real estate development policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for Real Estate Development ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in the management process to capture investment opportunities in this segment of the market.

II. STRATEGIC OBJECTIVE

Realizing attractive risk-adjusted returns is the strategic objective of the Program. Investors, managers, consultants, or other participants selected by the System targeting the real rate of return shall consider the stage in the development life cycle. The earlier in the development process, the greater the return expectation. Investments in real estate development shall target risk-adjusted returns higher than those of existing core real estate investments.

III. GENERAL

The amount of development undertaken shall be subject to investment guidelines as described in the individual policies adopted for apartments, industrial, office, and retail real estate investments. The Statement of Investment Objectives and Policies for Real Estate Equity Joint Ventures and the Statement of Investment Objectives and Policies for the Equity Real Estate Portfolio give additional guidance concerning development. Development activity shall be allowed in both Core and Specialized Portfolios. Both Portfolios are subject to policies specific to Core portfolio investing, limiting the amount of development allowed in each portfolio. The applicable property type policy and this Policy shall govern real estate investments.

The System shall generally invest in a development project only under the following circumstance. If entitlements are not obtained, the entitlement process should be free of private and governmental restrictions upon the intended development. Such restrictions include, but are not limited to, no-growth initiatives, building moratoriums, and conflicts with general plan amendments. Developments shall reasonably be expected to receive site plan approval in the ordinary course of business.

Parties suggesting investments in development projects other than those described above shall make a presentation to the System for their specific approval. Investments in the Single-Family Housing and Acquisition and Development Programs do not fall under this Policy.

IV. INVESTMENT VEHICLES

The System shall invest in development projects on a joint venture basis with development partners. Additionally, the System shall invest through investment advisors, both on a separate account basis and on a commingled fund basis. Investment advisors shall provide expertise in negotiating and monitoring development agreements.

V. SELECTION OF DEVELOPMENT PARTNERS

Development activities shall focus on strategic partnerships with quality developers. The investment manager shall control design, amenities, cost, and overall quality of construction projects. The System recognizes that the selection of a development partner is critical to the success of development project and for avoiding disputes that cost time and effort in their resolution.

Potential development partners shall be evaluated on past development and property management experience with projects of similar size and type in the specified geographic market. Additional evaluation factors include financial depth, liquidity, stability, and capital commitment to the project. Project personnel must demonstrate their experience and ability to perform all development related tasks, from construction management to leasing for projects of similar size and type in the specified market, and commitment to the company and project. Development partners must also have a long-term investment objective consistent with the System's. A previous successful working relationship with the investment advisor shall be viewed favorably. A potential partner's credentials, credit, professional references, and financial statements shall be evaluated prior to accepting a development proposal.

Generally, the System shall align interests of developers with itself and the development partners through capital contribution. For example, in the form of a letter of credit covering a cost overrun guarantee or imputed capital such as land at risk in the development.

VI. SELECTION OF ADVISOR

The System recognizes that the selection of a development advisor is critical for the success of a development project. The System shall approve investment advisors based on their successful history in negotiating and monitoring development investments. Potential development advisors shall be evaluated on their development and asset management capabilities. Evaluations shall include engineering and financial analysis, advisors' significant experience in monitoring or asset management of development investments or both, and thorough understanding of the issues involved in negotiating and making development investments. Advisors shall demonstrate their ability to successfully negotiate development agreements, experience in resolving disputes arising in development investments, and reliable track record in working with established developers. A potential development advisor's credentials, references, and financial statements shall be reviewed before selecting an advisor.

VII. MARKET AND DEVELOPMENT SELECTION CRITERIA

The System recognizes that market selection is critical to the success of a development project. The analysis includes consideration of socioeconomic, market, and neighborhood characteristics. Specific attention shall be directed toward current and future vacancy rates, which are based upon supply planned and under construction, regulatory controls, and employment growth.

In addition to market, property life cycle, and property type development guidelines, the analysis of potential development investments shall also be based on the physical and economic characteristics described in detail in the Investment Objectives and Criteria sections of the System's Statement of Core Apartment, Office, Industrial, and Retail Investment Policies.

Physical attributes considered shall include the site, property, size, exterior and interior characteristics, building services and amenities. Economic standards encompass analysis of the income and expense potential that will determine future cash flow and value enhancement.

VIII. INVESTMENT STRUCTURE

Development investment structures are not standard, but they are determined by the terms negotiated in the transaction. Therefore, investment advisors shall remain flexible in negotiating such agreements. In general, advisors shall maximize the potential for success in joint ventures by minimizing the creation of divergent interests among partners. As a rule, negotiated agreements shall be precise in the following areas:

A. **Equity joint ventures**

For all equity joint ventures, the advisors shall follow these guidelines:

1. Ownership: Ownership shall be subject to the Ownership and Developer Investment Share Guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures.

2. Leverage: Leverage shall be subject to the guidelines presented in the Statement of Objectives and Policies for Real Estate Leverage.

3. Distribution to Partners: Distributions shall be subject to the guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures. The System requires a cumulative preferred return and a minimum 50% share of proceeds once the cumulative preferred return has been met from property cash flow and sale or refinancing or both.

   The development partner's return may include participation in cash flow and sale, or refinancing proceeds and incentive participation, based on meeting or exceeding pro forma or budget thresholds. The System shall negotiate the preferred return and share of proceeds distributed to each partner, taking into consideration the relative risk each party is assuming. Additional negotiation factors include the share of total capital contributed by each partner, the current market terms for similar joint ventures, and the value enhancement and risk management elements for that development project contributed by each partner. The timing of the distribution to the developer may be based on meeting break-even point leasing requirements or completion or both and occupancy of phased construction projects.

4. Contributions: Contributions shall be subject to the guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures. The System

shall require, at a minimum, that the developer commit capital or risk capital (for example, through a letter of credit covering a cost overrun guarantee). The System shall recognize the imputed value of land with zoning, entitlement, and building permit approvals as an additional equity contribution by the developer partner.

5. Responsibility of Partners: A Development Services Agreement shall clearly identify the responsibilities of partners. The development partners' responsibilities shall included pre-development phase services such as initial planning, schematic design, design development, working drawings, contractor bidding, and selection. Development Phase services shall include construction management and administration. Development Phase reporting by the development manager shall include monthly reports regarding the construction status, budget-to-actual comparison for the project to that date, a summary of change orders in the month covered by the report, and any changes to the budget or schedule of the project.

6. Resolution of Disputes: Resolution of disputes shall be subject to the guidelines presented in the Statement of Objectives and Policies for Equity Joint Ventures. If a development partner fails to perform under the terms and conditions of the agreement with the System, it may replace them.

7. Transfer of Interests: Transfer of interests shall be subject to the guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures.

B. **Construction**

The System shall seek to mitigate construction risk, for example, through the use of maximum price guarantees, payment bonds, or completion bonds (also known as performance bonds), where appropriate. Development ventures that involve construction risk shall follow these guidelines:

1. Construction Cost Overruns: Construction cost overruns shall be subject to the guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures.

2. Cost Verification Procedures: The development advisor's engineering and construction staff, on behalf of the System, shall conduct the following procedures:

   a. Review and approve the construction budget;

   b. Review and approve plans and specifications;

   c. Reconcile construction bids to budget;

   d. Give authority to commence construction; and

   e. Prepare a monthly engineering inspection report.

   If invoices meet engineering inspection reports, the investment advisor shall make disbursements on a monthly basis.

IX. ASSET AND PROPERTY MANAGEMENT

Asset management is subject to the guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures. The developer or a fee manager selected by the developer shall provide property management services.

X. FEES

Advisor fees for development projects are subject to the guidelines presented in the Statement of Objectives and Policies for Equity Real Estate Joint Ventures. The System recognizes that additional risk may be involved in monitoring equity joint venture agreements and projects, specifically during the construction and development phases. Therefore, the System reserves the right to have advisors bid a different fee schedule for these services.